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04-CV-01510-CMP

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

RANDALL SIMON, On Behalf of Himself
and all Others Similarly Situated,

Plaintiff,

vs.

DRUGSTORE.COM, INC., KAL RAMAN,
ROBERT A. BARTON and SRIDHAR IYER,

Defendants.

No.

CV4 1510

CLASS ACTION

COMPLAINT FOR VIOLATION OF THE
FEDERAL SECURITIES LAWS

DEMAND FOR JURY TRIAL

COMPLAINT FOR VIOLATION OF THE
FEDERAL SECURITIES LAWS

LERACH COUGHLIN STOIA & ROBBINS LLP
700 Fifth Avenue, Suite 5600
Seattle, WA 98104
Telephone: 206-749-5544 Fax: 206-749-9978

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SUMMARY AND OVERVIEW

1. This is a securities class action on behalf of all purchasers of the publicly traded securities of drugstore.com inc. ("drugstore.com" or the "Company") between January 14, 2004 and June 10, 2004 (the "Class Period"), against drugstore.com and certain of its officers and directors for violations of the Securities Exchange Act of 1934 (the "1934 Act").

2. drugstore.com is an online provider of health, beauty, wellness, personal care, vision and pharmacy solutions.

3. During the Class Period, defendants issued materially false and misleading statements regarding the Company's business and prospects, causing drugstore.com securities to trade at artificially inflated levels.

4. The true facts which were known by each of the defendants, but concealed from the investing public during the Class Period, were as follows:

(a) the Company's gross margins were being negatively impacted due to its implementation of a free 3-day shipping promotion;

(b) the integration of Vision Direct was eroding the Company's margins;

(c) the Company's sales growth was being negatively impacted by cancellations resulting from expired prescriptions;

(d) the Company was not on track to "break even" but rather incur massive losses; and

(e) as a result of the foregoing, defendants lacked a reasonable basis for their positive statements about the Company and its earnings projections.

5. As a result of the defendants' false statements, drugstore.com shares traded at inflated prices during the Class Period, increasing to as high as \$7.91 on January 21, 2004, and the Company's top officers and directors sold more than \$4.7 million worth of their own shares.

JURISDICTION AND VENUE

6. Jurisdiction is conferred by §27 of the 1934 Act. The claims asserted herein arise under §§10(b) and 20(a) of the 1934 Act and Rule 10b-5.

7. Venue is proper in this District pursuant to §27 of the 1934 Act. Many of the false and misleading statements were made in or issued from this District.

8. The Company's principal executive offices are in Bellevue, Washington, where the day-to-day operations of the Company are directed and managed.

THE PARTIES

9. Plaintiff Randall Simon purchased drugstore.com publicly traded securities as described in the attached certification and was damaged thereby.

10. Defendant drugstore.com is an online provider of health, beauty, wellness, personal care, vision and pharmacy solutions.

11. Defendant Kal Raman ("Raman") was the President and Chief Executive Officer of drugstore.com until his resignation was announced on June 11, 2004. During the Class Period, Raman sold more than \$3.25 million worth (or 90%) of his drugstore.com stock.

12. Defendant Robert A. Barton ("Barton") was the Vice President, Finance and Chief Financial Officer of drugstore.com. During the Class Period, Barton sold more than \$1.2 million worth of his drugstore.com stock.

13. Defendant Sridhar Iyer ("Iyer") was the Vice President, Technology and Chief Information Officer of drugstore.com. During the Class Period, Iyer sold more than \$306,000 worth of his drugstore.com shares.

14. The individuals named as defendants in ¶¶11-13 are referred to herein as the "Individual Defendants." The Individual Defendants, because of their positions with the Company, possessed the power and authority to control the contents of drugstore.com's quarterly reports, press releases and presentations to securities analysts, money and portfolio managers and institutional investors, *i.e.*, the market. Each defendant was provided with copies of the Company's reports and

1 press releases alleged herein to be misleading prior to or shortly after their issuance and had the
 2 ability and opportunity to prevent their issuance or cause them to be corrected. Because of their
 3 positions and access to material non-public information available to them but not to the public, each
 4 of these defendants knew that the adverse facts specified herein had not been disclosed to and were
 5 being concealed from the public and that the positive representations which were being made were
 6 then materially false and misleading. The Individual Defendants are liable for the false statements
 7 pleaded herein at ¶¶17, 19-20 and 25-27, as those statements were each "group-published"
 8 information, the result of the collective actions of the Individual Defendants.

9 **SCIENTER**

10 15. In addition to the above-described involvement, each Individual Defendant had
 11 knowledge of drugstore.com's problems and was motivated to conceal such problems. Barton, as
 12 CFO, was responsible for financial reporting and communications with the market. Many of the
 13 internal reports showing drugstore.com's forecasted and actual growth were prepared by the finance
 14 department under Barton's direction. Defendants Raman, as CEO and President, and Iyer, as Chief
 15 Information Officer, were responsible for the financial results and press releases issued by the
 16 Company. Each Individual Defendant sought to demonstrate that he could lead the Company
 17 successfully and generate the growth expected by the market.

18 **FRAUDULENT SCHEME AND COURSE OF BUSINESS**

19 16. Each defendant is liable for (i) making false statements, *or* (ii) failing to disclose
 20 adverse facts known to him about drugstore.com. Defendants' fraudulent scheme and course of
 21 business that operated as a fraud or deceit on purchasers of drugstore.com publicly traded securities
 22 was a success, as it (i) deceived the investing public regarding drugstore.com's prospects and
 23 business; (ii) artificially inflated the prices of drugstore.com's publicly traded securities; (iii) allowed
 24 defendants to obtain larger bonuses which were directly tied to the performance of drugstore.com
 25 shares; (iv) allowed defendants to arrange to sell and actually sell in excess of \$4.7 million worth of
 26

1 drugstore.com shares at artificially inflated prices; and (v) caused plaintiff and other members of the
 2 Class to purchase drugstore.com publicly traded securities at inflated prices.

3 **DEFENDANTS' FALSE AND MISLEADING**
 4 **STATEMENTS ISSUED DURING THE CLASS PERIOD**

5 17. On January 14, 2004, drugstore.com issued a press release entitled "drugstore.com
 6 inc. Announces Preliminary Financial Results for the Fourth Quarter of Fiscal Year 2003; Company
 7 Anticipates 4Q03 Revenue Increase of 28% over 4Q02 and Indicates Key Profitability Milestone
 8 Achieved." The press release stated in part:

9 drugstore.com, inc., the leading online retailer of health, beauty, wellness, personal
 10 care, and pharmacy products, in connection with its upcoming presentation at the 2nd
 11 Annual SG Cowen Consumer Conference in New York, today announced
 12 preliminary financial results for the quarter ended December 28, 2003.

13 *drugstore.com, inc. announced that it expects record revenues reflecting a*
 14 *28% increase over revenues for the fourth quarter of fiscal year 2002, or*
 15 *approximately \$70.0 million in revenues for the fourth quarter of fiscal year 2003.*
 16 The company also expects to report profitability on an EBITDA basis for the further
 17 quarter of fiscal year 2003. EBITDA is a non-GAAP financial measure defined as
 18 earnings before interest, taxes, depreciation and amortization of intangible assets,
 19 non-cash marketing expense and stock-based compensation. A schedule of the
 20 expected range of estimated amounts to be used in reconciling expected net loss (the
 21 most directly comparable GAAP measure) to expected EBITDA profitability is
 22 provided supplementally below. In addition, drugstore.com, inc. expects to end
 23 fiscal year 2003 with more than \$40 million in cash and cash equivalents. These
 24 preliminary results are subject to revision upon completion of an audit of the full
 25 year's results by the company's outside auditors.

26 "In a very tough economy, we have been a high-growth retailer that has
 consistently outperformed the competition," said Kal Raman, president and chief
 executive officer of drugstore.com, inc. *"As a result of our relentless focus on*
convenience, selection, value and most importantly, trust, we are now well-
positioned to capitalize on the incredible growth opportunities in the \$273 billion
health, beauty, wellness, and pharmacy market."

18. On January 20, 2004, the Company issued a press release reporting record net sales of
 \$70.6 million for the quarter and a 59% year-over-year reduction in GAAP net loss and announced
 that it achieved EBITDA profitability.

19. Commenting on the January 20, 2004 press release, defendant Raman stated:

"The fourth quarter was an important milestone for drugstore.com, as we
 accomplished significant operational goals, including record sales, higher gross
 margins, and most importantly EBITDA profitability We also made significant

investments for the future, such as broadening our product mix by acquiring a leading online contact lens provider, launching new technology that makes it easier for customers to use their flexible spending accounts, and leading the effort to make the Internet safer for consumers shopping for online prescriptions. With these and other growth initiatives, we believe we can continue to grow the company profitably and build on our position as the leading provider of health, beauty, wellness, personal care and pharmacy solutions on the Web."

20. The press release also included the Company's outlook for first quarter 2004 and fiscal year 2004:

drugstore.com, inc. anticipates net sales for fiscal year 2004 to grow in excess of 45% over 2003, and be in the range of \$360 million to \$390 million. Of net sales, the company expects pharmacy mail order sales to be approximately 16%, local pickup pharmacy sales to be approximately 24%, eye care sales to be approximately 20%, and OTC sales to be approximately 40%. For fiscal year 2004, the company expects GAAP net loss in the range of \$9.5 million to \$13.5 million and EBITDA in the range of break-even to \$4 million. For the first quarter of fiscal year 2004, the company expects net sales to be approximately \$80 million to \$85 million, with mail order pharmacy sales at approximately 17% of net sales, local pickup pharmacy sales at approximately 28%, eye care at approximately 15%, and OTC sales at approximately 40%. Gross margin in the first quarter of 2004 is expected to be in the range of 21% to 22%. The company anticipates a GAAP net loss range of \$4.5 million to \$5.0 million and an EBITDA loss range of \$1.2 million to \$1.7 million for the first quarter, as the company anticipates increased marketing spending in the first quarter to drive additional growth into the newly acquired Vision Direct and the company's other base businesses.

21. The Company's shares spiked 13%, or \$.94, from \$6.97 to close at \$7.91 on a trading volume of 1.8 million shares.

22. From January 26, 2004 to March 30, 2004, defendant Barton sold 200,000 shares of his drugstore.com stock for proceeds of \$306,100.

23. From January 26, 2004 to April 18, 2004, defendant Raman sold 551,300 shares of his drugstore.com stock for proceeds of \$3.2 million.

24. From February 6, 2004 to February 12, 2004, defendant Iyer sold 40,000 shares of his drugstore.com stock for proceeds of \$262,000.

25. On April 28, 2004, drugstore.com announced its first quarter 2004 results. The Company provided a list of 15 highlights for the quarter, each of which painted a very promising picture:

- 1 • Net sales grew by 48% to \$84.4 million. Sales in the OTC segment grew by
2 48% to \$35.5 million, mail-order pharmacy sales grew by 24% to \$14.5
3 million, local pick-up pharmacy sales were flat at \$21.5 million, and sales in
the vision segment (created in December 2003 as a result of the acquisition of
International Vision Direct Corp.) were \$12.9 million.
- 4 • Average net sales per order increased by 10%, or \$7, to \$78. Average net
5 sales per order grew by 20% to \$60 for OTC, by 16% to \$129 for mail-order
6 pharmacy, and by 10% to \$101 for local pick-up pharmacy. Average net
7 sales per order for the vision segment were \$77.
- 8 • Order volume during the quarter exceeded 1 million orders, and grew by
9 33%.
- 10 • The trailing 12-month number of active consumers grew by 21% to 1.57
11 million. The average annual spend per active customer was \$174, up from
12 \$160. During the quarter, the company revised its trailing 12-month average
13 spend for Vision Direct customers to approximately \$110.
- 14 • Sales from repeat customers grew by 45% for the quarter, with revenue from
15 repeat customers representing 73% of total sales. Net sales from repeat
16 customers grew by 46% in OTC, by 21% in mail-order pharmacy, and by
17 14% in the local pick-up pharmacy. In the vision segment, 56% of sales were
18 generated from repeat customers.
- 19 • During the quarter, the Company added 306,000 new customers, bringing the
total customer base to over 5.1 million unique customers since inception.
- 20 • First quarter gross margin was 21.5%, up from 18.4%, and was benefited by
21 high growth in the OTC product sales and the addition of the vision segment.
- 22 • As expected, marketing and sales expense per new customer for the first
23 quarter was \$20, up \$3 from the fourth quarter of 2003, reflecting the
24 assumption and integration of Vision Direct marketing efforts.
- 25 • Fulfillment and order processing expenses declined as a percent of sales to
26 11.0%, down from 12.5%.
- Net loss on a GAAP basis for the first quarter was \$4.6 million, or \$0.06 per
share, and improved by 19%, or \$1.1 million.
- EBITDA loss (as previously defined) was \$961,000 for the first quarter of
2004.
- The Company reduced its accrued liability associated with employee
vacation by approximately \$400,000 and realized a corresponding benefit to
the first quarter's net loss and EBITDA loss, as a result of a new employee
vacation policy implemented in the first quarter.
- The Company capitalized labor of approximately \$200,000 associated with
technology integration of the Vision Direct Web store and back-end
operations.

- 1 • Employee headcount at the end of the quarter was approximately 600 employees.
- 2 • Annualized inventory for the first quarter was approximately 600 employees.

3 26. Again commenting on the quarter's results, defendant Raman stated:

4 "The first quarter of 2004 was an exciting quarter for us, as we began to see a
5 significant return from our growth initiatives. This was demonstrated by an
6 impressive 46% year-over-year growth in revenue from repeat customers in our over-
7 the-counter business, which shows that our customers are getting more from and are
8 doing more of their shopping at the drugstore.com Web store"

9 27. The April 28, 2004 release also provided guidance for the second quarter 2004 and
10 full fiscal year 2004:

11 For the second quarter of fiscal 2004, drugstore.com, inc. expects net sales to
12 be in the range of \$85 million to \$89 million. Of total net sales, the company expects
13 OTC sales to be in the range of \$36 million to \$38 million, mail-order pharmacy
14 sales to be in the range of \$15 million to \$16 million, local pick-up pharmacy to be in
15 the range of \$21 million to \$22 million, and vision to be approximately \$13 million.
16 The company plans to implement a new Free 3-Day Shipping service for OTC orders
17 of \$49 or more, which is expected to benefit West Coast customers in particular, and
18 also plans to increase spending on marketing to promote its newly acquired vision
19 business and the Free 3-Day Shipping service. As a result, the company anticipates a
20 GAAP net loss for the second quarter to be in the range of \$4.0 million to \$4.5
21 million, and EBITDA loss to be in the range of \$600,000 to \$1.1 million.

22 For the full fiscal year, drugstore.com, inc. confirmed its prior guidance that
23 net sales are expected to grow more than 45% over 2003, to a range of \$360 million
24 to \$390 million. The company adjusted its forecast of GAAP net loss for the full
25 fiscal year slightly, to a range of \$9.8 million to \$13.8 million. The company
26 maintained its prior EBITDA guidance for fiscal year 2004, with EBITDA in the
range of break-even to a profit of \$4.0 million, and believes that it will end the year
with more than \$40 million in cash. A reconciliation of forecasted net loss range to
forecasted EBITDA range (net loss is the most directly comparable GAAP measure)
is included in the financial data accompanying this press release.

27 28. On May 17, 2004, defendant Iyer sold 10,000 shares of his drugstore.com stock for
28 proceeds of \$44,100.

29 29. On June 11, 2004, before the markets opened, CEO Raman shocked investors with
30 his immediate resignation "to pursue other opportunities." Simultaneously with the press release
31 announcing Raman's resignation, the Company, less than 45 days after issuance of positive guidance
32 on April 28, 2004, issued another release lowering its expected revenue for the second quarter 2004
and fiscal year 2004:

1 For the second quarter of 2004, drugstore.com currently expects revenues to
2 increase by approximately 50 percent year-over-year, in line with previous guidance
3 of \$85 to \$89 million, with a GAAP net loss of approximately \$4.5 million to \$5.2
4 million. The company expects to report an EBITDA loss (a non-GAAP financial
5 measure defined as earnings before interest, taxes, depreciation and amortization of
6 intangible assets, non-cash marketing expense and stock-based compensation) of
7 \$1.1 to \$1.8 million for the second quarter. This would represent a significant
8 improvement over an EBITDA loss of \$2.1 million reported for the same period last
9 year, but is below previous guidance of an EBITDA loss of \$600,000 to \$1.1 million.

6 "We expect our second quarter results to be impacted by a dip in gross
7 margins to approximately 20.3 percent"

8 ... For fiscal year 2004, the company adjusted its previous forecast of GAAP
9 net loss to a range of \$15.8 million to \$17.8 million and adjusted its prior EBITDA
10 guidance to an EBITDA loss in the range of \$2.0 to \$4.0 million.

10 30. Immediately following the Company's release, drugstore.com's stock plunged from
11 its closing price of \$4.91 on June 10, 2004 to a closing price of \$3.06 on June 14, 2004, on volume
12 of 3.8 million shares.

13 31. Whitaker Securities LLC senior analyst Marc Bettinger, who was surprised by the
14 announcement, stated:

15 "The company's dramatic announcement that its 2004 sales would be lower,
16 EBITDA would swing \$5 million (from midpoint to midpoint) to negative territory
17 and that its CEO was resigning does little to inspire confidence in the story"

18 32. Bettinger also found "Mr. Raman's stepping down and timing of such disquieting."
19 Whitaker downgraded drugstore.com stock to "under perform" from "market perform."

20 33. The façade of growing strength in the Company's operations, which artificially
21 inflated the value of drugstore.com stock, occurred at just the perfect time for defendants to sell
22 millions of dollars worth of drugstore.com stock.

23 34. The true facts which were known by each of the defendants, but concealed from the
24 investing public during the Class Period, were as follows:

25 (a) the Company's gross margins were being negatively impacted due to its
26 implementation of a free 3-day shipping promotion;

(b) the integration of Vision Direct was eroding the Company's margins;

(c) the Company's sales growth was being negatively impacted by cancellations resulting from expired prescriptions;

(d) the Company was not on track to "break even" but rather incur massive losses; and

(e) as a result of the foregoing, defendants lacked a reasonable basis for their positive statements about the Company and its earnings projections.

FIRST CLAIM FOR RELIEF

For Violation of §10(b) of the 1934 Act and Rule 10b-5 Against All Defendants

35. Plaintiff incorporates ¶¶1-34 by reference.

36. During the Class Period, defendants disseminated or approved the false statements specified above, which they knew or deliberately disregarded were misleading in that they contained misrepresentations and failed to disclose material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

37. Defendants violated §10(b) of the 1934 Act and Rule 10b-5 in that they:

(a) Employed devices, schemes, and artifices to defraud;

(b) Made untrue statements of material facts or omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or

(c) Engaged in acts, practices, and a course of business that operated as a fraud or deceit upon plaintiff and others similarly situated in connection with their purchases of drugstore.com publicly traded securities during the Class Period.

38. Plaintiff and the Class have suffered damages in that, in reliance on the integrity of the market, they paid artificially inflated prices for drugstore.com publicly traded securities. Plaintiff and the Class would not have purchased drugstore.com publicly traded securities at the prices they paid, or at all, if they had been aware that the market prices had been artificially and falsely inflated by defendants' misleading statements.

39. As a direct and proximate result of these defendants' wrongful conduct, plaintiff and the other members of the Class suffered damages in connection with their purchases of drugstore.com publicly traded securities during the Class Period.

SECOND CLAIM FOR RELIEF

For Violation of §20(a) of the 1934 Act Against All Defendants

40. Plaintiff incorporates ¶¶1-39 by reference.

41. The Individual Defendants acted as controlling persons of drugstore.com within the meaning of §20(a) of the 1934 Act. By reason of their positions as officers and/or directors of drugstore.com, and their ownership of drugstore.com stock, the Individual Defendants had the power and authority to cause drugstore.com to engage in the wrongful conduct complained of herein. drugstore.com controlled each of the Individual Defendants and all of its employees. By reason of such conduct, the Individual Defendants and drugstore.com are liable pursuant to §20(a) of the 1934 Act.

CLASS ACTION ALLEGATIONS

42. Plaintiff brings this action as a class action pursuant to Rule 23 of the Federal Rules of Civil Procedure on behalf of all persons who purchased drugstore.com publicly traded securities (the "Class") on the open market during the Class Period. Excluded from the Class are defendants.

43. The members of the Class are so numerous that joinder of all members is impracticable. The disposition of their claims in a class action will provide substantial benefits to the parties and the Court. Drugstore.com had more than 78 million shares of stock outstanding, owned by hundreds if not thousands of persons.

44. There is a well-defined community of interest in the questions of law and fact involved in this case. Questions of law and fact common to the members of the Class which predominate over questions which may affect individual Class members include:

- (a) Whether the 1934 Act was violated by defendants;
- (b) Whether defendants omitted and/or misrepresented material facts;

1 (c) Whether defendants' statements omitted material facts necessary to make the
2 statements made, in light of the circumstances under which they were made, not misleading;

3 (d) Whether defendants knew or deliberately disregarded that their statements
4 were false and misleading;

5 (e) Whether the prices of drugstore.com's publicly traded securities were
6 artificially inflated; and

7 (f) The extent of damage sustained by Class members and the appropriate
8 measure of damages.

9 45. Plaintiff's claims are typical of those of the Class because plaintiff and the Class
10 sustained damages from defendants' wrongful conduct.

11 46. Plaintiff will adequately protect the interests of the Class and has retained counsel
12 who are experienced in class action securities litigation. Plaintiff has no interests which conflict
13 with those of the Class.

14 47. A class action is superior to other available methods for the fair and efficient
15 adjudication of this controversy.

16 **PRAYER FOR RELIEF**

17 WHEREFORE, plaintiff prays for judgment as follows:

- 18 A. Declaring this action to be a proper class action pursuant to FRCP 23;
19 B. Awarding plaintiff and the members of the Class damages, interest and costs;
20 C. Awarding reasonable costs, including attorneys' fees; and
21 D. Awarding such equitable/injunctive or other relief as the Court may deem just and
22 proper.

23 **JURY DEMAND**

24 Plaintiff demands a trial by jury.
25
26

1 DATED: July 1, 2004

LERACH COUGHLIN STOIA
& ROBBINS LLP
TAMARA J. DRISCOLL, WSBA #29212

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4 
TAMARA J. DRISCOLL

5 700 Fifth Avenue, Suite 5600
6 Seattle, WA 98104
7 Telephone: 206/749-5544
206/749-9978 (fax)

8 LERACH COUGHLIN STOIA
9 & ROBBINS LLP
10 WILLIAM S. LERACH
11 DARREN J. ROBBINS
401 B Street, Suite 1700
San Diego, CA 92101
Telephone: 619/231-1058
619/231-7423 (fax)

12 GELLER RUDMAN, PLLC
13 SAMUEL H. RUDMAN
14 DAVID A. ROSENFELD
200 Broadhollow Road, Suite 406
Melville, NY 11747
15 Telephone: 631/367-7100
631/367-1173 (fax)

16 Attorneys for Plaintiff

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COMPLAINT FOR VIOLATION OF THE
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LERACH COUGHLIN STOIA & ROBBINS LLP
700 Fifth Avenue, Suite 5600
Seattle, WA 98104
Telephone: 206-749-5544 • Fax: 206-749-9978